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TreeLife

AIFS IN INDIA

An Overview



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Overview

Alternative Investment Funds, often abbreviated as AIFs, have become a buzzword among sophisticated investors, especially High Net Worth Individuals (HNIs).

As of September 2023, India has 1,200+ registered AIFs. This domain has witnessed remarkable growth, underscored by the 30% surge in commitments which escalated from INR 6.41 trillion in the fiscal year 2021-22 to a staggering INR 8.33 trillion in 2022-23. This growth translated to a substantial jump of INR 1.92 trillion within a year!

The total assets under management (AUM) of AIFs have grown at a CAGR (Compound Annual Growth Rate) of 28% over the last five years¹.

In light of the burgeoning AIF industry, its regulatory authority, the Securities and Exchange Board of India (SEBI), hasn't remained a silent observer. SEBI has proactively been fortifying protocols to guarantee investor safety, heighten transparency, and ensure fair practices within the AIF guidelines.

So, the question arises, what exactly are AIFs? And how do they function within the Indian regulatory landscape?

¹ <https://aifpms.com/blog/growth-of-aif-pms-investments-in-india/>

Understanding AIFs

An AIF is a privately pooled investment vehicle that gathers funds from investors, Indian or foreign, for investment as per a defined investment policy to benefit its investors.

With their promise of high returns across diverse asset classes, AIFs are attractive for those aiming to diversify and enhance their portfolios.

Some key terms used in AIFs:

Carry

Carry or carried interest is akin to performance fees which is paid to the investment manager as a share of the AIF's profits which the investment manager is entitled to if they exceed a specific threshold return. Carry is typically in the range of 15-20% of the profits earned by the AIF in excess of the specified threshold.

Hurdle / Preferred rate of return

Minimum percentage of returns that an investor earns before the Investment Manager can catch-up and charge carry to the investor.

Catch-up

Catch-up allows the investment manager to earn the hurdle rate of return on its investment in the AIF but only after the investors have received their investment along with the hurdle rate of return on such investment.

Distribution waterfall

Provides for an order of specified priority in which the distributions are made by AIF which includes the capital contributions, fees, hurdle, catch up (if any), carry, etc.

Closing

Closing is the date fixed by the Investment Manager as a cut-off date to obtain capital commitment from investors.

Regulatory Framework

In India, AIFs operate under the purview of the SEBI.

Since their establishment in the late 1980s, Venture Capital Funds (VCFs) have been a significant focus for the government to bolster the growth of specific sectors and early-stage companies. However, the desired outcomes in supporting emerging sectors and startups were not realized, largely due to regulatory uncertainties. Recognizing this challenge, in 2012, the Securities and Exchange Board of India unveiled the SEBI (AIF) Regulations. This was done to categorize AIFs as a unique asset class, similar to Private Equities (PEs) and VCFs.

Any entity wishing to function as an AIF must seek registration with SEBI. While there are various legal structures under which an AIF can be established - such as a trust, a company, an LLP, or a body corporate - trusts are the most commonly chosen form in India.

A typical AIF structure looks like the following:

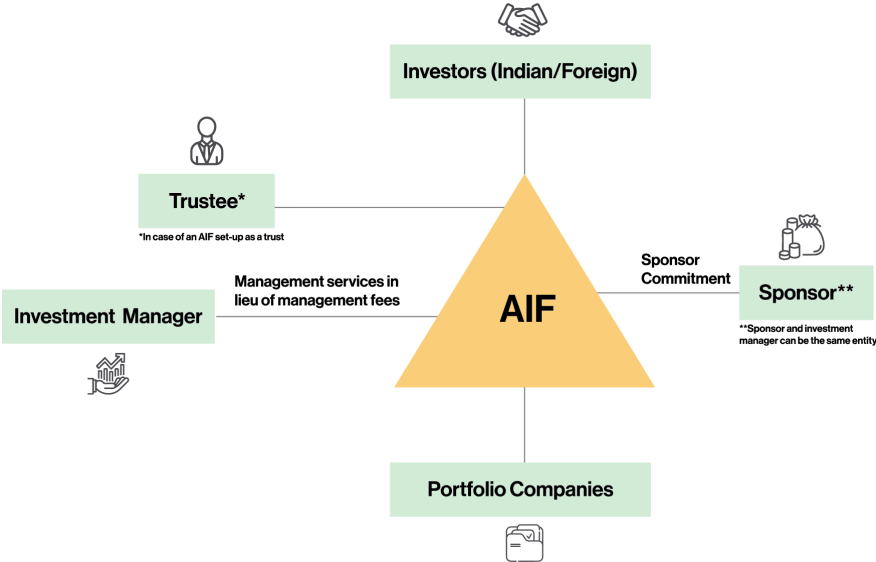


Figure 1: Typical AIF structure

The entities are:

- Settlor - Person who settles the trust with a nominal initial settlement
- Trustee - Person in charge of the overall administration and management of the Trust. In practice, this responsibility is then outsourced to the investment manager.
- Contributor - Investor to the Trust (AIF) and makes a capital commitment to the AIF
- Sponsor - Face of the AIF i.e. Person who sets up the AIF
- Investment Manager - Brain of the AIF i.e. Person who is appointed to manage the investments

It's noteworthy that the roles of the Sponsor and Investment Manager can be unified, with one entity performing both functions.

Under the SEBI AIF Regulations, AIFs are classified into 3 distinct categories. Each category serves a unique purpose and is characterized by specific investment conditions and varying degrees of regulatory oversight. Below is an overview of the categories, highlighting their primary purpose and key conditions:

Parameters	Category I AIF	Category II AIF	Category III AIF
Definitions	Funds with strategies to invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable.	Funds that cannot be categorized as Category I AIFs or Category III AIFs. These funds do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as	Funds which employ diverse or complex trading strategies and may employ leverage including through investment in

	<p>Includes:</p> <ul style="list-style-type: none"> • Venture Capital Funds (angel funds are a subcategory of VCFs) • SME funds • Social Impact Funds • Infrastructure Funds • Special Situation Funds 	<p>permitted in the AIF Regulations.</p> <p>Examples - Private Equity or Debt Funds</p>	<p>listed or unlisted derivatives.</p> <p>Examples - Hedge funds or funds which trade with a view to make short-term returns</p>
Minimum ticket size	INR 1 crore	INR 1 crore	INR 1 crore
Minimum fund size	INR 20 crore	INR 20 crore	INR 20 crore
Open or close ended fund	Close-ended	Close-ended	Can be open or close-ended
Tenure	Minimum tenure of 3 years	Minimum tenure of 3 years	NA
Continuing interest of Sponsor / Manager (a.k.a skin in the game)	<p>Lower of:</p> <ul style="list-style-type: none"> • 2.5 % of corpus • INR 5 crores 	<p>Lower of:</p> <ul style="list-style-type: none"> • 2.5 % of corpus; • INR 5 crores 	<p>Lower of:</p> <ul style="list-style-type: none"> • 5 % of corpus; • INR 10 crore
Investment outside India	Permissible subject to SEBI approval		

Concentration norms	Can't invest more than 25% in 1 investee company	Can't invest more than 25% in 1 investee company	Can't invest more than 10% in 1 investee company
Borrowing	Cant borrow funds except for : (a) temporary funds not more than 30 days (b) less than 4 occasions in a year (c) less than 10% of investable funds	Cant borrow funds except for : (a) temporary funds not more than 30 days (b) less than 4 occasions in a year (c) less than 10% of investable funds	Can engage in leverage & borrowing as per prescribed rules
Overall restrictions / compliances	Low	Medium	High
SEBI registration fees	INR 500,000	INR 1,000,000	INR 1,500,000
Per scheme filing fees	INR 100,000	INR 100,000	INR 100,000

Table 1: Categories of AIFs

Apart from the categories mentioned above, any of the three categories of AIFs can be classified as a large-value fund (LVFs), provided that each investor is an “accredited investor” as per the AIF Regulations and invests a minimum of INR 70 crores in the AIF. LVFs have certain investment and compliance related exemptions.

Angel Funds also hold a distinct categorization under the AIF Regulations. These funds are a subcategory of Category I AIFs - VCFs, primarily designed to acknowledge and support the

unique role of angel investors in the startup ecosystem. The key characteristics of Angel funds are summarized below:

Parameters	Category I AIF
Minimum ticket size	INR 25 lakhs
Minimum fund size	INR 5 crore
Investments	Should be not less than INR 25 lakhs and not more than INR 10 crores, with a minimum lock-in period of 3 years.
Open or close ended fund	Close-ended
Continuing interest of Sponsor / Manager (a.k.a skin in the game)	Lower of: <ul style="list-style-type: none"> • 2.5 % of corpus • INR 50 lakhs
Investors	Angel investors who meet the specified criteria
SEBI application fee	INR 200,000
Per scheme filing fee	NIL

Table 2: Angel Funds

Taxability of AIFs

Category I and II AIFs:

Category I and II AIFs are granted pass-through status from an income-tax perspective, whereby any income earned by these AIFs (other than profits or gains from business) is not taxed at the AIF level, but directly taxed as income at the hands of the investors as if these investors had directly received this income from the investments.

Unabsorbed losses (other than business losses) of the AIF may be allocated to the investors for them to set off against their respective individual incomes, subject to such investors having held the units in the AIF for at least 12 months.

Further, the distributions from Category I and II AIFs are subject to a withholding tax of 10% in the case of resident investors, and at the rates in force in the case of non-resident investors (after giving due consideration to any benefit available to them under the applicable tax treaty).

Business income of Category I and II AIFs is chargeable to tax at the maximum marginal rate (MMR) i.e. 30% plus applicable surcharge and education cess at the AIF level as per the legal status of the AIF and once this tax is paid, no further tax on the same is payable by the investors.

Category III AIFs

Category III AIFs have not been granted statutory pass-through status. Typically, they are set up as “determinate and irrevocable trusts.” This means the trusts have identifiable beneficiaries, and their respective beneficial interests can be determined at any given time. In such trusts, the trustee can discharge the tax obligation for the income of the trust on behalf of its beneficiaries (i.e., the investors) in a representative capacity. This is similar to the tax liability an investor would face if they had received the income directly. However, there's an exception: trusts with any business income must pay tax at the MMR. As per income-tax law, tax

authorities can recover tax either from the trustee or directly from the beneficiaries. Given this flexibility, a trustee might opt to pay the entire tax amount at the AIF level. Moreover, the law permits the trustee (acting as a representative assessee) to recover from investors any taxes it has paid on their behalf.

We have not covered tax implications for investment managers and sponsor entities above.

Key Documents

Private Placement Memorandum (PPM):

The PPM provides comprehensive details about the AIF. Contents include information about the manager, key investment team, targeted investors, proposed fees and expenses, scheme tenure, redemption conditions or limits, investment strategy, risk factors and management, conflict of interest procedures, disciplinary history, service terms and conditions by the manager, affiliations with intermediaries, winding up procedures, and any other relevant details helping investors make informed decisions about investing in an AIF scheme.

SEBI has introduced mandatory templates for PPMs (for and) which provides for two parts:

Part A – section for minimum disclosures

Part B – supplementary section to allow full flexibility to the AIF in order to provide any additional information, which it may deem fit.

There are two templates - one for [Category I and II AIFs](#) and the other for [Category III AIFs](#).

Angel Funds, LVFs and AIFs in which each investor commits to a minimum capital contribution of INR 70 crores are exempted from following the aforementioned template.

Indenture of Trust / Trust Deed:

This document is an agreement between the settlor and the trustee. It involves the settlor transferring an initial settlement (can be nominal) to the trustee to create the fund's assets. The Indenture details the roles and responsibilities of the trustee.

Investment Management Agreement:

This agreement is entered between the trustee and the investment manager. Here, the trustee designates the investment manager and transfers most of its management powers regarding the fund to them. However, certain powers retained by the trustee are outlined in the Indenture of Trust.

Contribution Agreement:

This agreement is between the contributor (investor), the trustee, and the investment manager. It mentions the terms of an investor's participation in the fund, covering areas like beneficial interest computation, distribution mechanism, expense list to be borne by the fund, and the investment committee's powers. SEBI mandates that the Contribution Agreement's terms should align with the PPM and shouldn't exceed its provisions.

How to get registered with SEBI?

This is the registration process if the Fund is set up as a Trust.

To register an AIF with SEBI, the fund needs to make an application to SEBI on its online portal.

The trust deed i.e. incorporation document of the fund where it is set up as a trust, needs to be registered with the local authorities. Further, the PAN needs to be obtained before making the application to SEBI.

The application to SEBI has the following key documents to be submitted:

- Application form in Form A
- Private Placement Memorandum (PPM)
- Trust Deed
- Declarations and KYC documents of the entities involved i.e. investment manager, sponsor, trustee (if the AIF is structured as a trust), and the AIF itself

Further, before submitting the application to SEBI, the AIF must engage a merchant banker who performs due diligence on the PPM and subsequently provides a certification that needs to be filed with SEBI. However, there's an exemption for LVFs and Angel Funds for this requirement.

Once the application is submitted, SEBI will evaluate the application. Generally, the entire setup and registration process, including SEBI's assessment, spans around four to six months.

Broadly, the process flow looks as follows:

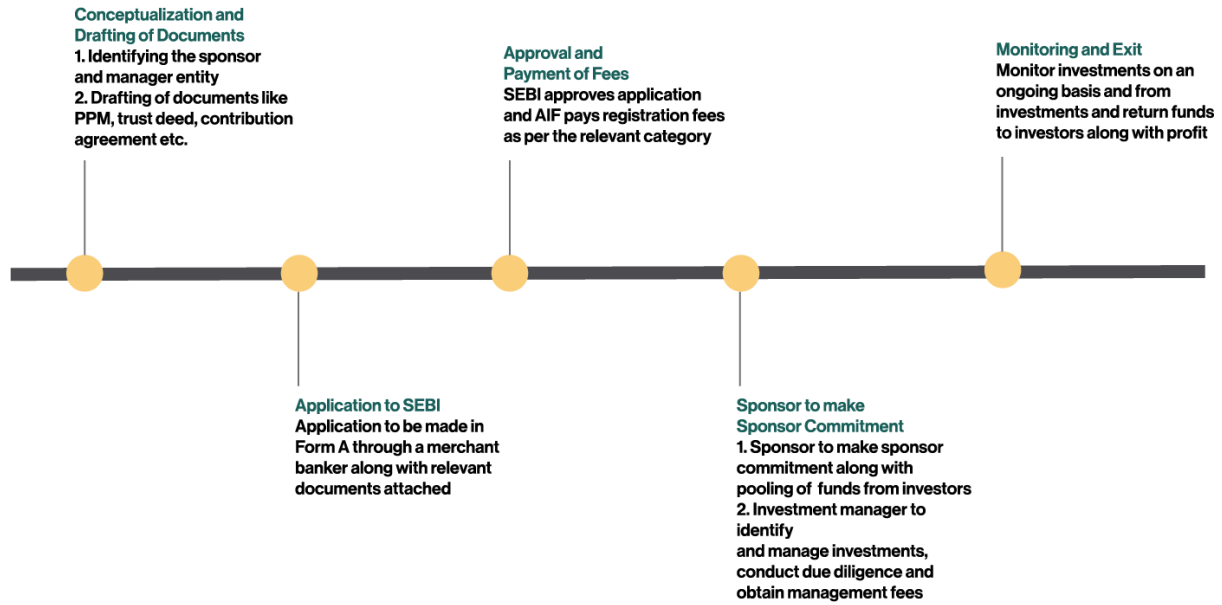


Figure 2: AIF process flow

Final Thoughts

With their ability to diversify investment portfolios and provide potential high returns, AIFs undeniably present an attractive avenue for investment in today's dynamic market scenario. The regulatory framework, set by SEBI, ensures transparency, credibility, and alignment with global best practices, further instilling confidence among stakeholders.

However, AIFs can be tricky to understand because of the different types, how they are taxed, and the many documents involved. It's like trying to put together a puzzle with lots of pieces.

For both potential AIF managers and investors, understanding this intricate ecosystem is crucial. It is recommended to talk to experts who know the details. They can guide you through the process, help you understand the rules, and make sure you're making the best decisions. As the world of AIFs keeps changing, staying informed and getting the right advice will be key to success.

FAQs:

1. What is an Alternative Investment Fund (AIF)?

Answer: An AIF is a privately pooled investment vehicle that collects funds from investors, either Indian or foreign, to invest as per a defined investment policy, with the aim of benefiting its investors. It offers diversified asset classes and promises potentially high returns, making it an attractive choice for High Net Worth Individuals (HNIs) and other discerning investors.

2. How are AIFs regulated in India?

Answer: AIFs in India operate under the regulatory framework of the Securities and Exchange Board of India (SEBI). SEBI introduced the SEBI (Alternative Investment Funds) Regulations in 2012 to categorize AIFs as a distinct asset class. All entities desiring to function as an AIF must register with SEBI.

3. What are the different categories of AIFs?

Answer: SEBI classifies AIFs into three categories:

- Category I AIF: Focus on sectors or areas which are socially or economically desirable. Includes Venture Capital Funds, SME funds, and more.
- Category II AIF: Funds that do not fall under Category I or III and don't undertake excessive leverage.
- Category III AIF: Funds employing diverse or complex trading strategies, often using leverage. Examples include hedge funds.

4. How is the taxability of AIFs determined?

Answer:

- Category I and II AIFs: Granted pass-through status, meaning income (other than business profits) is taxed directly in the hands of investors.
- Category III AIFs: Not granted a statutory pass-through. Typically, tax liability for trusts can be met by the trustee or the beneficiaries directly.

5. What are Angel Funds and how do they fit into the AIF landscape?

Answer: Angel Funds are a subcategory of Category I AIFs – specifically Venture Capital Funds. They are designed to support the crucial role of angel investors in the startup ecosystem. Angel funds have distinct features like a minimum ticket size of INR 25 lakhs and a minimum fund size of INR 5 crores.

6. How does one register an AIF with SEBI if set up as Trust?

Answer: To register with SEBI, the fund must make an online application. Prior to this, the trust deed must be registered locally, and a PAN should be obtained. Key documents like the PPM, Trust Deed, and relevant KYC documents must be submitted. The entire setup and registration process usually takes around four to six months.

7. What is the typical cost for setting up an AIF in India?

Answer: The typical cost for setting up an AIF in India ranges from INR 10 to 15 lakhs. The SEBI registration fees depend on the Category of AIF. We have prepared an indicative cost sheet for a Category II AIF [here](#) which gives an overview of the costs.

Want to Know More?

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